

## Legal Insights

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### Private Funds in the Cayman Islands

This article will provide a general overview of the steps involved in the formation and running of a closed-ended investment fund in the Cayman Islands pursuant to the Private Funds Act (As Revised) (the “**Act**”).

#### Type of legal entity used in formation of a private fund

Whilst there are no statutory requirements as to the type of legal entity that should be used in the establishment of a closed-ended fund pursuant to the Act, the type of entity most commonly used for this purpose is the Exempted Limited Partnership (“**ELP**”). Whilst other types of corporate vehicles can be used, such as a Cayman Islands Exempted Company, these are more commonly deployed in the context of an open-ended investment fund pursuant to the Mutual Funds Act (As Revised).

#### Who runs a private fund?

If a closed-ended fund (referred to under the Act as a private fund) is structured as an Exempted Company, it will be the directors of that company who operate it. However, as part of the registration of the fund with the Cayman Islands Monetary Authority (“**CIMA**”), it will be necessary to ensure that there are at least two directors appointed; this is known as the “four eyes principle” to ensure proper corporate governance and investor protection and is a prerequisite for registration as a private fund with CIMA.

If the fund is established as an ELP, the two-director rule does not apply directly to the ELP as ELPs do not have separate legal personality and therefore do not have directors. An ELP must, however, have a qualifying “general partner” who operates the ELP on behalf of the limited partners. It is at the general partner level that the “four eyes principle” will apply in this context and so a general partner must also have at least two directors.

Presently, it is not necessary for the directors of a private fund (or the directors of a general partner of an ELP which is registered as a private fund) to be registered pursuant to the Directors Registration and Licensing Act (As Revised).

#### Private Funds Act – obligation to register as a private fund

Only closed-ended funds that fall within the definition of a “private fund”, as defined in the Act, will be required to register with CIMA under the Act as a private fund and will be regulated as such. The Act

defines a “private fund” as:

*“...a company, unit trust or partnership that offers or issues or has issued investment interests, the purpose of effect of which is the pooling of investor funds with the aim of enabling investors to receive profits or gains from such entity’s acquisition, holding, management or disposal of investments, where –*

*(a) the holders of investment interests do not have day-to-day control over the acquisition, holding, management or disposal of the investments; and*

*(b) the investments are managed as a whole by or on behalf of the operator of the private fund, directly or indirectly...”*

The term “investment interest” is defined in the Act as an interest in the issuing vehicle which carries an entitlement to participate in the profits or gains of the vehicle and which interests are not redeemable or re-purchasable at the option of the investor.

Whether a particular structure will fall within this definition and be subject to regulation can be highly nuanced. We therefore recommend that you speak with an experienced Cayman Islands investment funds attorney to determine whether your proposed project would be regulated or whether an exemption from registration might be available.

For example, the Act itself contains a list of “non-fund arrangements” which are not considered to be “private funds”. The list of non-fund arrangements is extensive and quite broad in remit but we would specifically highlight the following non-fund arrangements:

- Joint ventures;
- Proprietary vehicles;
- Holding vehicles;
- Debt issues and debt issuing vehicles;
- Structured finance vehicles; and
- Sovereign wealth funds.

It should also be noted that single investor funds will also fall outside of the remit of the Act on the basis that where there is only one investor, there will not be any “pooling of investor funds” as required by the above quoted definition of “private fund”.

### **Registration as a Private Fund under the Act**

Where a particular project falls within the definition of a “private fund” and where it is not a “non-fund arrangement”, the corporate vehicle will be required to apply to CIMA for registration as a private fund under the Act.

In order to be registered under the Act, the fund will need to submit a completed application to CIMA via its online portal together with supporting documentation, including its offering document (which should contain, as a minimum, the information specified by CIMA in its Rules on Content of Offering Memorandum) and evidence of the appointment of an auditor and an administrator.

The application must (per section 5 of the Act) be submitted to CIMA (together with payment of the applicable registration fee) within 21 days after its acceptance of capital commitments from investors for the purposes of investments (although the application can be submitted at any time before capital commitments are received). The fund must be registered with CIMA as a private fund before it receives

any capital contributions from investors.

## Regulatory obligations of private funds

In addition to the above, there are certain other key obligations with which private funds must comply.

Where the fund makes any change (or becomes aware of any change) which materially affects any information that was delivered to CIMA as part of the fund's registration as a private fund, it must file details of the change with CIMA within 21 days of the change taking effect or of the fund becoming aware of the change. Whilst the Act only requires 'material' changes to be notified to CIMA, in practice CIMA tends to be notified of all changes given what is 'material' is open to interpretation.

Private funds must also file an annual return with CIMA and pay an annual registration fee in order to maintain its registration.

## Ongoing requirements

The Act requires that private funds have in place certain mechanisms and safeguards relating to an annual audit of the fund, the valuation of the fund's assets, the safeguarding of the fund's assets, cash monitoring and the identification of securities.

- **Audit** – the fund must engage an approved Cayman Islands auditor to prepare its audited financial statements annually. CIMA maintains a list of the approved auditor firms who are able to provide this service. Such audited financial statements must be filed with CIMA within six (6) months of the end of each financial year of the fund.
- **Valuation of fund assets** – the assets of a private fund must be valued periodically. What is considered to be an appropriate period between valuations will depend on the asset class(es) in which the fund is invested. However, valuations should, as a minimum, be carried out at least annually. Each valuation must be carried out by an independent and suitably qualified professional valuer who is familiar with the relevant asset class. If the valuer is not independent, then CIMA reserves the right to have the valuation independently verified at the cost of the fund. Otherwise, if the valuation of assets is carried out by the fund itself or by its investment manager, the valuation function must be independent from the portfolio management function of the fund and any conflicts of interest are required to be identified, managed, monitored and disclosed to investors.
- **Safeguarding of the fund's assets** – private funds are, generally speaking, required to appoint a custodian to hold, in segregated accounts maintained in the name of the fund, the fund's assets which are capable of physical delivery or capable of registration in a separate account except that the private fund shall not be required to appoint a custodian if it has notified CIMA and it is neither practical nor proportionate to do so, having regard to the nature of the private fund and the type of assets it holds. The duty of custodian appointed is to verify the fund's title to its assets based on information provided by the fund together with any externally available information. If a custodian is not appointed, the verification of the fund's title to its assets must be carried out either by the fund's administrator or by the fund itself or its investment manager. In the case of title verification by the fund or its investment manager, the title verification function must be independent from the portfolio management of the fund and any conflicts of interest are required to be identified, managed, monitored and disclosed to investors in the fund.
- **Cash monitoring** – private funds are required to appoint any of an administrator, custodian or the investment manager to (1) monitor the cash flows of the fund; (2) ensure that all cash has been booked in cash accounts maintained in the name of the fund; and (3) ensure that payments

made by investors to the fund for the purposes of investment have been received. If such monitoring is not undertaken by an independent third party, CIMA reserves the right to have the cash monitoring verified at the cost of the fund. In the case of cash monitoring undertaken by the fund or its investment manager, as above, the cash monitoring function must be independent from the portfolio management of the fund and any conflicts of interest are required to be identified, managed, monitored and disclosed to investors in the fund.

- **Identification of securities** – if the private fund in question regularly trades securities or holds them on a consistent basis, it must keep records of the identification codes (such as ISIN codes or CUSIP codes) of those securities that it trades and holds, and such records must be made available to CIMA on request.

### Other obligations

In addition to its obligations under the Act and guidance issued by CIMA, private funds are also subject to other obligations under the laws of the Cayman Islands in relation to matters such as FATCA / CRS compliance and, in respect of anti-money laundering legislation and regulations.

- **FATCA / CRS** – Private funds tend to be classified as ‘Reporting Financial Institutions’ for the purposes of FATCA and CRS. Each private fund is therefore required to undertake detailed due diligence on each of its investors (which is typically undertaken on its behalf by its administrator). The fund must also provide information to the Tax Information Authority of the Cayman Islands in respect of each of its investors who constitute ‘reportable accounts’.
- **Anti-money laundering** – Private funds conduct “relevant financial business” for the purposes of the Proceeds of Crime Act (As Revised) and the Anti-Money Laundering Regulations (As Revised) (being together the “**AML Requirements**”). Private funds are therefore required to have robust policies and procedures in place to ensure that the AML Requirements are adhered to. The fund must have a detailed Anti-Money Laundering Compliance Manual which contains detailed guidance on the policies and procedures that must be followed in carrying out the fund’s activities, ranging from the onboarding process for investors, record-keeping, processes for the reporting of suspicious activity and other risk management matters.
- **Beneficial ownership** - The Beneficial Ownership Transparency Act (“**BOTA**”) requires Cayman Islands exempted companies, ELPs, and limited liability companies to maintain a beneficial ownership register unless an alternative route to compliance applies. Under the BOTA, alternative routes to compliance are available to categories of legal persons such as private funds and each private fund will be required to provide its corporate services provider in the Cayman Islands with:
  - i. written confirmation of the category into which it falls; and
  - ii. the required particulars specific to it.

The private fund is required to appoint a principal point of contact (“**PPoC**”) who is responsible for responding to any request for beneficial ownership information received from the Cayman Islands Competent Authority (“**Competent Authority**”) in relation to the private fund. The PPoC must be licensed in the Cayman Islands and will be required to provide the requested beneficial ownership information to the Competent Authority within 24 hours of a request being made, or such other timeframe as may be stipulated in the request.

Each private fund must also appoint three (3) officers to assist with compliance with the AML Requirements; these are the anti-money laundering compliance officer, money laundering reporting officer, and deputy money laundering reporting officer.

## Economic Substance

On the basis that private funds are a form of investment fund, private funds that are registered under the Act are not 'relevant entities' for the purposes of the International Tax Co-operation (Economic Substance) Act (As Revised). Whilst, therefore, private funds will not be required to demonstrate the extent of their 'substance' in the Cayman Islands, they will nonetheless be required to make an annual notification under this legislation to confirm their status as an investment fund.

## Conclusion

If you are considering establishing a private fund in the Cayman Islands, it is imperative that you have experienced Cayman Islands legal counsel by your side to assist you in navigating the legislative, regulatory, and compliance landscape. We have a strong reputation for our technical excellence, responsive, forward-thinking and insightful approach to advising clients on offshore Investment Funds and would be happy to be your trusted advisor on the formation, launch and ongoing advisory of your Cayman Islands private fund.

## Further Assistance

This publication is not intended to be a substitute for specific legal advice or a legal opinion. If you require further advice relating to the matters discussed in this Briefing, please contact us. We would be delighted to assist.

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